THE TRADITION OF CHANGE IN JAPAN

by

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Abstract

Japan's slow growth in the 1990s has raised concerns that Japanese political and economic institutions are not responding effectively to domestic problems and increased global competition. But Japan's stagnant macroeconomic performance masks structural changes and economic reforms now underway. These changes are gradually transforming Japanese institutions from their traditional role as supports for catch-up growth to the needs of a mature economy. This paper is the introduction to a forthcoming volume that takes a forward-looking view at important trends for the coming decade and their implications for Japan, its markets and its relationship with the world.

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1. Introduction

By the early 1990s, Japan had emerged as the main challenger to the United States for the position as the world's leading economy. The Japanese economy had outgrown the US for several decades, and the appreciation of the yen had pushed Japanese per capita income (calculated on an exchange-rate basis) almost 50 per cent above US levels in 1995. Japanese export industries generated massive export surpluses, despite the appreciated currency. The Japanese success was considered nothing less than a miracle.

The past decade has been less miraculous. The collapse of the stock market boom and real estate bubble around 1990 marked the beginning of a decade of stagnation. The over-hang of bad debt paralyzed the financial sector, and the Japanese government initiated few reforms of the banking system until the end of the decade. Since 1992, annual real GDP has grown only 1 per cent on average.[1] Poor economic performance has persisted despite ambitious macroeconomic measures taken throughout the 1990s to restore growth.

The low growth rates of the 1990s are partly due to cyclical factors, and these have been exacerbated by ill-conceived and poorly executed macroeconomic and financial policies. But the chaos in macroeconomic policymaking has demonstrated the challenges facing the country's economic institutions in coping with a changing environment. Many of these institutions were designed in the 1950s to facilitate the rapid accumulation of resources in a converging, developing economy. By the end of the 1980s, Japan had become a wealthy country at the industrial cutting edge, with a rapidly aging population, and facing very different external conditions. The transition to new institutions compatible with Japan's mature economy is now underway, and the structure of the Japanese economy is changing, with the pace of change varying dramatically across different sectors of the economy.

The new Japan emerging from this institutional facelift has still not been fully revealed. Japan is clearly borrowing elements from the Anglo-American formula of deregulated product and financial markets, smaller government and lower taxes, free trade, and privatization, and yet no one expects the new Japanese economy to emerge looking exactly like the US and UK economies. There are several fundamental reasons for this. First, Japan's factor and resource endowments differ substantially from those in the United Kingdom and the United States and may require a somewhat different set of political and economic institutions for the endowments to be used efficiently. Second, institutional change is typically a path dependent process (North, 1990), in which the future path of institutional change is conditioned by earlier institutional development. The special features and the interlocking nature of Japanese economic institutions certainly increase the likelihood that new institutions will retain a uniquely Japanese face.

The process of institutional change also depends on the ability of politicians, intellectuals, and managers to fashion an ideological consensus around distinct types of institutional change. The 1990s have, however, been a turbulent period for Japan politically, with new political parties forming and reforming, national governments enjoying less support and spending shorter terms in office, and major institutional reforms already in place, e.g. the voting system for the Diet, and waiting in

[1] Through Sept. 1999.

the wings, e.g. the reorganization of government agencies and the financial "Big Bang." In this turbulent political environment, it remains an open question whether the Japanese public will support institutional reforms that support future growth (Curtis, 1999). A rapidly aging population could become increasingly conservative and reject institutional change—or, sensing the crisis of current institutions, embrace economic and political change as more promising for their golden years.

Our specific objectives in this volume are two-fold:

- To analyze the ongoing demographic, structural, and institutional changes currently transforming Japan's economy.
- To identify factors likely to induce structural and institutional change in Japan's economy over the next twenty-five years and to use economic theory, simulation modeling, econometric techniques, and cross-country comparisons to provide insights on the likely course of these changes.

Over the next 25 years, Japan will transform the way it produces, consumes, trades, and governs itself. By focusing on the forces underpinning such institutional and structural change, this volume's essays aim to provide a clearer understanding of these changes. We caution that while some of our authors may claim to have seen a glimpse of the future, the reader surely knows the limits to such prognostication. No one can tell precisely what Japan's future will bring. What we can do is to identify and analyze the direction and intensity of current trends, look for the presence of the usual suspects producing institutional change, and see what we can learn from Japan's historical responses to similar challenges. Our intent is clear: to provide a unique forward-looking perspective on the future path of Japan's economy and its relationship to the rest of the world.

2. The Japanese Economy: From Miracle to Stagnation

Japan was the first and archetypal Asian Miracle economy. Between 1950 and 1973, the Japanese economy doubled in size every seven years, rising rapidly to a place among the world's major economies. Japan's development success spawned a generation of imitators in Asia and would-be imitators in Latin America and the rest of the developing world. By the late 1980s, the period of rapid growth had all but ended, but by then, Japan had achieved one of the highest living standards in the world, Japanese multinationals had become common household names around the globe, and Japanese foreign investment was spurring growth in developed and developing countries alike.

While the perception in the West is of a Japan that "rose from the ashes" of World War II to global strength, the country's rapid industrialization began in the late 19th century (see e.g. Howe, 1996). Following the Meiji Restoration in 1868, Japan made a fairly quick transition onto a path of modernization and development. During the 1870s modern institutional structures in banking, police, post and telegraph, armed forces, primary and secondary schooling, and the judiciary were borrowed from Western European countries and the United States and modified to fit Japanese circumstances. From this solid institutional base, real output in Japan between 1880 and 1940 grew by nearly 3.5 per cent per year (Ito, 1992)). Over this sixty-year period, the economy gradually switched from being primarily a producer of agricultural products to a producer of light manufactures, e.g. textiles, light industrial goods, and services. Large, integrated businesses, known as *zaibatsu*, came to dominate manufacturing and finance.

Immediately after the Second World War, Japan's economy grew slowly as various political and economic reform measures were implemented, with varying degrees of success. With the start of the Korean War in June 1950, American purchases of raw materials and manufactured goods for the war effort sparked new Japanese economic growth that lasted far beyond the end of the Korean War. Between 1950 and the onset of the first oil crisis in 1973, the economy expanded at a 10 per cent annual rate. This was the era of rapid expansion in Japanese heavy industry—iron, steel and chemicals—a sector which had benefited from wartime pressures to innovate and supply the Japanese military machine with products previously purchased overseas. This era also saw the emergence of new strength in automobiles and the infant consumer electronics industry. Japan became famous for its powerful Ministry of Finance (MOF) and Ministry of International Trade and Industry (MITI), which helped direct economic development through subsidies and other incentives.

By 1973, Japan's real GDP per capita in purchasing power parity terms stood at 59 per cent of the US level, compared with 17 per cent in 1950. (Heston et al., 1995). It would be 79 per cent of the US level by 1990. In little more than two decades, Japan had closed most of its gap in output and living standards with the rest of the developed world.

There is by now a well-established view of the forces that propelled Japan to rapid growth. (See, for example, Flath, 2000, Ito, 1992, James, Naya and Meier, 1989, Patrick and Rosovsky, 1976, and World Bank, 1993.) Japan was able to maintain a very high domestic savings rate (30-35 per cent of GDP in the 1960s) that supported high rates of investment in new plant and equipment. Savings were in turn supported by prudent macroeconomic policies that restrained inflation and promoted wealth accumulation. A strong financial system and capital controls on external inflows and outflows assured that saved resources would be channeled to productive domestic investment. Strong primary and secondary schooling provided Japan with a well-educated work force that could provide the human resources needed for growth.

The government's intervention in "picking winners" is more controversial. At the same time, its encouragement of export development forced Japanese manufacturing companies to develop world-class efficiency, while protectionism in early years probably played a role in facilitating the growth of infant industries. Japan was also lucky enough to have access to the very open and large American market during this period, as well as the protection of the US security umbrella.

Japan's growth had tailed off by the early 1970s. In part, the external macroeconomic environment had become less benign. After the end of the Bretton Woods monetary system in 1971-73, Japan had adopted an expansionary monetary stance to hold down the yen's appreciation. When the OPEC oil price shock hit in 1973, a large inflationary spurt occurred. Japan suffered a recession in 1974 and saw inflation of more than 30per cent that year. Investment rates fell in the 1970s, and output growth slowed to the 5per cent per year range in the late 1970s. This slowdown in economic growth was partly due to the lingering effects of the OPEC oil price shock, but more fundamentally it also reflected the rapidly diminishing returns to new investment as Japan converged to other developed market economies.

In the 1980s, mushrooming Japanese current account surpluses and the massive associated outflow of capital presented new economic and political challenges for the country. As the US economy surged in 1983-85 and the dollar soared in value, US imports from Japan rose dramatically, prompting protectionist pressures. Worse for Japan, imports were concentrated in a high-profile, unionized industry—automobiles—so that a policy response was inevitable. The US had already imposed voluntary export restraints on Japanese automobiles in 1981, and these were maintained, albeit at slightly higher levels, throughout the decade. In 1985, President Reagan for the first time imposed "Super 301" trade sanctions against Japan, giving the administration authority to retaliate against alleged Japanese barriers to imports.

Growing current account imbalances prompted G5 countries to agree in 1985 to coordinated action to reduce the value of the dollar on world markets. Whether as a result of the September 1985 Plaza Accord and subsequent central bank interventions or market forces that were already correcting the overvalued currency, the dollar fell from 238 yen to 154 yen by June 1986.[2]

In the post-1985 *endaka* period, Japan found itself squeezed between two conflicting problems. On the one hand, the dramatically rising yen was severely harming profitability and competitiveness of Japan's export producers; on the other hand, the trade deficit with the US was stubbornly slow to close, so that Japan continued to face international pressure to reduce its trade surplus. To halt further appreciation of the yen, Japanese monetary policy shifted toward a more expansionary stance. Between 1985 and 1987, the Bank of Japan discount rate was cut in half, from 5per cent to 2.5 per cent, and it remained at this level through 1989. At the same time, Japan embarked on a program of financial liberalization, partly in response to foreign pressure for more open competitive markets.

The combination of financial liberalization and monetary expansion is generally blamed for creating—or at least accommodating—asset price inflation in the second half of the 1980s (Ito, 1996). First stock and then land prices rose dramatically after 1985, more or less doubling in value over several years. The rapid rise in wealth, as well as measures to liberalize trade, stimulated consumption spending and helped to close a large portion of the trade surplus by the end of the decade. Financial liberalization had allowed major manufacturing firms to bypass banks in raising investment funds, and banks had consequently lost some of their best business. They responded by refocusing on real estate lending. The lower-quality, over-extended loan portfolios left Japanese financial and non-financial firms exposed to considerable risk. When monetary policy was tightened in 1989 and 1990, stock and land prices quickly shed most of their gains of the previous four years.

Japan's economy entered a growth recession in 1992. Output growth fell from the 4-5 per cent range in the 1980s to 1 per cent in 1992 and 0.3 per cent in 1993. In part the slump was homegrown, the result of monetary contraction and widening bad debt problems from the collapse of Japan's "bubble economy." But the external environment

[2] For an interesting behind-the-scenes look at international financial politics during this period see Volcker and Gyohten, 1992.

also turned very unfavorable. A global economic slowdown began in the second half of 1990 and was exacerbated by Gulf War disruptions of commerce.

Japan's slowdown was not particularly notable, but its failure to recover as the 1990s wore on drew increasingly critical domestic and international attention. Growth was less than 1 per cent through 1994, and did not break 2 per cent until 1996. The Japanese government responded by implementing highly publicized fiscal measures to try to stimulate aggregate demand and spark a recovery. Five fiscal packages were enacted between 1992 and 1995, with a cumulative official size of 54 trillion Yen (Yashiro and Ito, 1995). Measures were undertaken to support land prices and to assist troubled financial institutions. Monetary policy became increasingly expansionary. But economic growth remained stagnant. There was a brief pickup in 1995-96, but the economy soon faltered once again with a premature increase in the consumption tax. Stagnant growth turned to outright recession with the Asian financial crisis of 1997.

There is much room for debate about the causes of Japan's extended weakness; some consideration of this issue is taken up below. Clearly the fiscal stimulus provided by the government in early years was not as large as advertised, since a part of the stimulus packages was previously-announced spending. The back-loading of some government spending may have driven up long-term interest rates and encouraged appreciation of the yen (McKibben, 1996). In addition, the government reversed course on fiscal policy when the economy began to expand mid-decade, raising the consumption tax and undercutting growth. But microeconomic problems also plagued the economy. Many Japanese firms and banks entered the 1990s with a heavy debt burden left over from the bubble years. Many manufacturing firms had substantial excess capacity after the investment boom of the 1980s (Makin, 1996). Slow growth in the 1990s in part reflected the need to work down these excesses through negative investment and, finally, layoffs. The institutional resistance to these changes has prolonged complete recovery.

3. Risutora

Post-WWII Japan has been characterized by a high level of governmental involvement and regulation in many industries. Japan's post-war development strategy was fundamentally grounded on a public-private partnership. The government sought to modernize the economic base by selecting promising industries and actively nurturing capacity by limiting competition, supporting research, development, and technology transfers, and encouraging the extension of credit to its favored targets. Industries with a potential to achieve economies of scale and scope were particularly favored and permitted to form horizontal and vertical cartels that cooperated on pricing, R&D, and production cutbacks during industry recessions. Japan has viewed American competition policy as encouraging waste—unregulated competition in oligopolistic industries that leads to excessive entry and unnecessarily high production costs, wasteful advertising expenditures, and duplication of R&D costs. The government also aimed to protect a variety of special interests supporting the governing party, the Liberal Democratic Party (LDP). Farmers, small retail shops, and service providers were protected against competition through a complex system of licensing, regulation, and quality control standards.

This close partnership between business interests and the Japanese government is in direct contrast to the Western, and particularly the American model, which is grounded in a tradition of strong antitrust policy, market competition, and private ownership. The American occupying authorities incorporated American antitrust laws and institutions into their package of reforms for the Japanese economy, but the effort to impose a vigorous antitrust policy floundered when priorities changed with the start of the Korean War in June 1950. The independent antitrust institutions imposed by the Americans were nominally retained, but effectively sidelined when the American occupation ended in April 1952, and various ministries assumed control over the nominally independent commissions.

The Americans occupying authorities were more successful in imposing other parts of their "revolution from above" on the Japanese economy, including wide-ranging land and tenancy reform programs, the breakup of *zaibatsu* holding companies and the removal of *zaibatsu* family members as controlling shareholders, and promotion of worker rights. In an ironic twist, the American occupying authorities were also partly responsible for the extensive regulatory powers that Japanese bureaucrats would exercise throughout the high-growth period. Beginning in April 1949, President Truman's "economic czar" for Japan, Joseph Dodge, used two large, centralized ministries, the Ministry of Finance (MOF) and the new Ministry of International Trade and Industry (MITI), to push through his program via a series of directives. Dower (1999) observes that that "for decades to come, the ministry [of Finance] continued to exercise exceptional prerogatives *vis-à-vis* other ministries and the Diet in controlling budgetary and monetary policy." (p. 544)

The 1950s saw the emergence of the mature form of numerous economic institutions commonly associated with Japanese business. Throughout the decade, companies formerly part of a *zaibatsu* group began to re-affiliate through interlocking stockholdings. The resulting horizontal *keiretsu* usually consisted of a main bank, industrial enterprises, and other financial firms; it was characterized by joint ventures among group firms, extensive intra-group purchasing, and loosely integrated group decision making.[3] Lifetime employment, bonus payments, seniority wages, and enterprise unions became institutionalized as employment practices of virtually all large corporations.

More controversial than the above business practices was Japanese industrial policy. Under the direction of MITI, some industries were targeted as ones in which Japan would have a future comparative advantage. MITI employed a wide array of methods to promote favored sectors, including subsidized credit, subsidies for cooperative R&D research, preferential access to foreign exchange, and multiple tax incentives. These explicit tools were complemented by "administrative guidance," an informal system of regulation administered by MOF and MITI bureaucrats. Based on the licensing function of these ministries, administrative guidance provided a flexible means of adjusting policy towards targeted industries. Some industries were targeted by MITI not for sunrise potential, but for sunset reorganization. In these industries, typically raw materials and labor-intensive manufactures, MITI organized "recession" and "rationalization" cartels to ease the adjustment burden of output cutbacks. Weinstein

[3] The text describes a horizontal keiretsu. Several other types of interfirm linkages were common. See Flath (2000) for a more complete exposition.

(1995) found that in the mid-1960s, over 1,000 government-sanctioned cartels were in place involving over 43 per cent of all manufacturing output.

The effectiveness of Japanese industrial policy has been much debated since the 1970s. Johnson (1982), Fallows (1994), Prestowicz (1988) and other political scientists have argued that MITI's industrial policy was the key to Japan's rapid post-war growth. Economists have been more guarded in their evaluation. Weinstein and Beeson (1996) found that industries receiving government assistance did not register particularly strong productivity gains. Others have argued that MITI's policies were not large enough to provide the stimulus ascribed to them.

The constant focus on the effectiveness of Japanese industrial policy has often obscured its ongoing transformation, a process that began in the late 1960s. The use of officially sanctioned cartels declined dramatically in the 1970s and 1980s; a program of (semi-) privatization of state-owned railroads, utilities, and Japan Tobacco was phased in during the 1980s; financial reform lifted controls on interest rates and many foreign exchange transaction in the late 1970s and 1980s; and import restrictions were removed or liberalized in numerous sectors.

Yet, as the downturn of the 1990s refused to go away, Japan slowly began deregulating a wide variety of industries in which regulation was still relatively intact, including transportation, communication, energy, and financial, insurance, and real estate industries. Pressure for deregulation came not only from within, but also from global competitive forces exercising an increasingly large influence on Japanese industries. The broad program of financial deregulation being phased in through 2003 (known as the "Big Bang") was partly motivated by domestic political considerations, but the overriding force behind its adoption was from the rapid decline of Tokyo in the 1990s as a world financial center. Other developing countries have pushed Japan to adopt arrays of proposed reforms, but they have little success in getting Japan to follow through on their agendas. At the start of the 21st century, economic forces appear to be more important than political or ideological forces in spurring industrial reform.

Deregulation in Japan has followed a uniquely Japanese model, just as regulation assumed uniquely Japanese forms. It has provided firms with increased freedom to adjust prices and output and has prompted additional firms to enter various industries. It has, however, not meant the end of administrative guidance, although it has meant a dramatic change in the attitude of MOF and MITI regulators towards competition. While the heavy hand of the regulator has been lifted from the controls, the administrative apparatus still lurks in the background.

At the turn of the century, gloomy reports are still dominating the macroeconomic picture of Japan, yet extensive changes are occurring at the microeconomic level. The ongoing crisis is forcing the government to implement reforms, although the pace has slowed down during the administration of Prime Minister Obuchi. In the long run, these reforms will act to create new markets, attract foreign investment, and stimulate competition. Foreign acquisitions of Japanese firms grew more than sixfold in value during 1998, and are continuing to grow (though volume is still small). Compared with foreign rivals, many Japanese firms are either too small or too dependent on their home market to survive. By paring away jobs and unprofitable businesses, they are restructuring to regain competitiveness. This process – known as *risutora* – is rapidly changing those sectors of the Japanese economy that are open to competition.

Throughout its history, Japan has risen to various challenges by restructuring its society and economy. The changes during this century have been particularly dramatic. Japan has moved from agriculture and low-tech manufacturing to high quality and high tech sectors. Its present problems have already led to extensive reforms and will undoubtedly lead to more over the next decade. Many of the policies needed for a prosperous future are already in place, and the structural changes needed to get the growth machine working again are in progress. If Japan can finally find the right mix of macroeconomic policies to overcome the current deflationary bias, we may yet be surprised by the vigor with which the underlying economy responds.

4. **Organization of the Book**

The volume's 14 essays were selected to cover important aspects of Japan's economy that are likely to undergo substantial change over the next 25 years. Our introductory chapter takes stock of Japan's position at the end of the 20th century and provides a brief sketch of the process of restructuring now underway. The remaining essays explore past trends and potential future developments in three broad areas: the macro-economy, the organization of industry, and the global economic and political environment. Short introductions to each chapter follow.

4.1. A Changing Macroeconomic Climate

Japan's growth success has been characterized both by high rates of accumulation of resources and rapid technological catching up. In recent decades, economic growth has outstripped absorption, so that current account surpluses and capital outflows have become the norm. Macroeconomic conditions supported this growth, including a young and growing population that generated a large pool of savings and workers, rapidly-growing demand abroad that provided markets for Japanese exports, and stable macro policies that favored savings, an educated work force, and long-term business planning.

These macro conditions are changing. As Japan's economy approaches the technological frontier in many areas, as its citizenry ages and becomes wealthier, and as external conditions change, the macroeconomic environment is likely to evolve very differently than in the past. The likelihood of lower growth rates coupled with rapid aging will pose severe challenges for macroeconomic policymaking.

Fundamental changes in Japan's macro economy may already be evident in the poor performance of the past decade. It is not a simple matter to determine how much of the 1990s slump is attributable to structural causes, and how much may simply reflect a cyclical downturn. Some, like Krugman (1998) and Ito (1996), have attributed a large role to policy errors both in the onset of the crisis and its intractability. Japan's central bank allowed excessive monetary expansion during the bubble economy period of the late 1980s and then faltered, both in providing adequate fiscal stimulus and in dealing with the banking crisis in the 1990s. But others (Ito, 1996 and Weinstein, 1996) have also seen indications of fundamental emerging growth problems for Japan's economy.

David Weinstein views Japan's 1990s performance in historical perspective in *Chapter 2*. He asks whether domestic and foreign observers may be too pessimistic about Japan's performance during the 1990s because they have attributed too much of the crisis to structural rather than cyclical factors. He argues that there is a general tendency to give excessive weight to structural explanations for Japan's fortunes, going as far back as Japan's first modern crisis in the 1880s and as recently as Prestowitz's (1988) concern that the US and Japan were trading places. Looking at the historical record, Weinstein concludes there is nothing peculiar about the 1990s slowdown. He writes, "…with the exception of the immediate postwar experience, recessions and periods of relative stagnation have always been a feature of Japanese economic development."

Weinstein does not completely dismiss structural explanations for Japan's recent growth slowdown. But if an argument is to be made that Japan has a performance problem, it must be related to evidence of productivity problems in particular sectors. Here, he finds that while there has been significant convergence in Japanese manufacturing productivity in recent decades, non-manufacturing sectors have actually fallen further behind their American counterparts. Why have non-manufactures fared so poorly? Weinstein observes that the poorest performers in this group are also the industries that are most heavily regulated—agriculture, construction, transportation, and communications. To Weinstein, this represents Japan's primary structural problem. Other service sectors must be permitted to follow the road of financial services, where deregulation appears to have improved productivity performance.

It is by now widely appreciated that Japan is leading the developed world in the progression toward an aged society. Increased life expectancy and falling fertility rates have reduced population growth and shifted an increasing share of the population into older age categories. By 2010, overall population growth is likely to cease and the number of elderly will surpass those younger than 20. As Andrew Mason and Naohiro Ogawa forcefully argue in *Chapter 3*, these demographic changes will represent powerful forces of macro change in years to come, affecting the size of the labor force, rates of saving and capital formation, the burden on social infrastructure, and the ongoing evolution of family and social institutions.

The demographic transformation in Japan during the 20th century was dramatic. According to Mason and Ogawa, at the end of the 19th century, life expectancy in Japan was 40 years, and more than 50 per cent were under the age of 20. Population growth surged with a reduction in mortality rates early in the 20th century, but tapered off by 1960 with declining fertility rates. Today, Japan has the highest life expectancy of any country, and the average woman has only 1.4 children. While there are uncertainties surrounding these forecasts—of future marriage and fertility behavior, mortality improvements, and immigration policy—it is virtually certain that Japan's population will begin to decline early in the 21st century.

Extrapolating from the demographic projections to their likely economic effects is a more difficult enterprise that raises some intriguing questions. The total labor force is likely to decline, but how much of this might be offset by higher female participation rates? By a reversal of the trend toward earlier retirements? Will government policies be altered to remove retirement incentives or to permit significant immigration? Mason and Ogawa consider each of these issues in turn.

An important macroeconomic effect of population aging is a potential decline in Japan's famously high savings rate. Empirical studies of Japanese savings have, however, reached widely differing conclusions. To place the issue on a firm conceptual footing, Mason and Ogawa view Japan's savings decision within a life-cycle framework that relates the demand for household wealth—and therefore the evolution of savings over time—to macro and demographic determinants. The model predicts first a rise in savings rates as the aging population builds assets for retirement, followed by a decline to a lower steady-state savings rate.

How far will the savings rate fall? Mason and Ogawa offer an estimate midway between the low or negative net savings rates implied by macro-based econometric models and the much higher savings rates typically found by studies that extrapolate results of household survey data. Both of these empirical approaches have flaws that suggest caution in interpreting some of the more extreme predictions. In particular, Mason and Ogawa are doubtful about forecasts of sharply negative net savings rates. They write, "[i]n the absence of more complete support, such drastic declines in savings strike us as alarmist."

The problem of forecasting savings rates clearly involves many of the same policy uncertainties that arise with projecting labor force participation rates. For example, will the modern social safety net permit reductions in private savings, or will the fiscal burden of rising social security outlays require cutbacks that force an increased reliance on private savings? There are also important links between demographic change, savings behavior, and the evolution of Japanese social arrangements. As Mason and Ogawa explain, there is evidence of a gradual breakdown of traditional family ties, with elders relying less on their children for support. This may raise savings needs, but also reduce the amount of money set aside for bequests.

Notwithstanding the many complexities that arise, Mason and Ogawa's conclusion for the Japanese macro economy are clear: Japan will likely grow much slower in the future than it has in the past. Its growth increasingly will need to be driven by productivity improvements and offshore production, rather than domestic factor accumulation.

The projected decline in savings rates has implications for Japan's overall balance of payments position. The past two decades have seen the emergence of large and persistent Japanese current account surpluses, as the country's excess of savings over investment has flowed abroad. Japan's export of financial capital has supported global investment and growth, but the accompanying trade balance deficit has created political tension in some countries such as the US. With the projected decline in savings rates, financial changes that may affect the willingness to invest abroad, and the continued strengthening of the yen, Japan's current account surplus could soon become a distant object in the rear view mirror.

In *Chapter 4,* F. Gerard Adams and Byron Gangnes evaluate prospects for Japan's current account balance. They begin by reviewing the macroeconomic causes of Japan's ongoing surpluses. In large part, surpluses in recent years can be attributed to the life-cycle considerations that have favored high savings, as described by Mason and Ogawa in Chapter 2. But the economy's rapid rate of growth through the 1980s may also have boosted savings, as did government net savings in the 1980s. And Japan's strong appetite for foreign assets has prevented yen appreciation that might otherwise have begun to close the trade gap.

What developments are likely to affect the current account in coming years? Clearly population aging will work to lower the surplus, to the extent that it reduces savings and redirects demand toward non-traded products and services. Investment may also fall off as a smaller work force reduces demands for capital, but Adams and Gangnes conclude that overall net savings are still likely to fall. Two other structural changes are likely to affect the current account: Japan's increasing reliance on imports from Asia and financial liberalization associated with Japan's Big Bang. While the former should reduce the surplus, the effects of the latter are harder to predict.

To the extent that these forces push Japan toward a lower current account path, they will also create pressure for structural adjustment at the level of individual industries. A decline in the surplus means a decline in net exports and so a shift of production toward non-tradable goods and services. These changes may in turn impose painful macroeconomic costs during the transition period. Adams and Gangnes explore the effects of such change using simulations of a large-scale macro-econometric model. In three simulations—import opening, aging, and financial liberalization—the authors illustrate likely effects on the macro-economy and on particular sectors. Adams and Gangnes conclude that while a smaller surplus may be welcome to Japan's trade partners, there may be rough waters ahead for Japanese industry.

If the current account may ultimately be headed lower, prospects for Japan's fiscal balance are also for greater deficits. The same aging process that reduces net savings outflows will create significant fiscal challenges for Japan's government. Recently, the budget deficit has soared to nearly 10 per cent of GDP as the government has attempted to jump-start the moribund economy. Much of the recent deficit increases are, of course, cyclical, but in just a few years an aging population will place increased pressure on public pension systems and other social services at the same time that income and tax revenue growth slows. This scenario is not unique to Japan, but like the aging process overall, the urgency of the problem is greatest here.

Charles Horioka analyzes prospects for Japan's public pension system in *Chapter 5*. He describes the evolution of the existing system, its inherent problems, and some proposals for reform. To Horioka, the problems with the pension programs go well beyond solvency. He argues that in their current form the programs have an adverse impact on the inter- and intragenerational allocation of resources, on private labor supply decisions, and on tax compliance.

Patterned after programs in other developed economies, Japan's public pension programs are pay-as-you-go systems, with benefits for current retirees funded by taxes on current workers. As Horioka explains, the origins of such systems are easy to explain: they permit a mechanism for redistributing income from a relatively-prosperous current generations to less well-off older generations, and they delay a part of the financing burden to later years. Other aspects of Japan's system also appear to stem from political expediency, such as the exclusion of dependent spouses from taxation, introduced in the 1980s. Japan was late in setting up its public pension programs, with universal coverage only in 1961. Benefit levels were increased sharply in the early 1970s, with Japan's emergence as a rich, highly developed country.

While the structure of Japan's pay-as-you-go system is understandable, Horioka argues that it has undesirable economic effects. Projected lifetime benefits far exceed contributions for current retirees, with the reverse for the current working-age population. The rapid aging of Japan's population contributes to this problem as does unrealistically high levels of current benefits. Within age cohorts, the burden is also uneven, primarily because of the exemption of bonuses and lump-sum retirement payments from taxation, and because of the exemption of spouses with income below a threshold level. The tax exemption for spouses also discourages female labor supply, as does income testing of retirees' pension benefits and their ability to "double dip" retirements and unemployment benefits. And the pay-as-you-go system may reduce national savings.

What should be done to address these problems? Horioka argues for an immediate move to an actuarially fair system, where expected pension benefits are matched with pension contributions. The burden of the government's net contributions to the program should be spread out as evenly as possible over current and future generations. Intragenerational inequities should be redressed by ending tax exemptions for non-working spouses, bonus income, and lump-sum retirement income as well as limiting benefit deductions for high-income retirees. Extending the mandatory retirement age would also help address incentive problems and the likely future labor shortages.

Unfortunately, recent government reform proposals do not measure up very well to this yardstick. The Ministry of Health and Welfare/Liberal Democratic Party proposal includes a number of changes to reduce growth in future pension outlays. Although some elements reduce intragenerational inequities, as a whole the program would make intergenerational burdens even more pronounced. Horioka prefers a competing proposal by Hatta and Oguchi, but acknowledges that there are severe political obstacles to any plan that would reduce current benefits or raise current taxes dramatically.

Japan has long been known for its perennially low rates of unemployment. While measurement differences may somewhat exaggerate Japan's labor market performance, there is little doubt that Japanese labor market institutions generate an unusually high level of employment stability and low rates of job turnover. The system of lifetime employment commitments may have been a useful tool during the period of rapid economic development, as it facilitated a reliable supply of labor to industry and reduced worker uncertainty. At the same time, the low unemployment rate reduced the need for the social safety net programs that represent a major drain on public finances in other industrialized countries.

The long 1990s slump has led to a significant rise in the unemployment rate, and has raised concerns that traditional employment practices may be stifling firm productivity. In *Chapter 6*, Marcus Rebick looks for evidence that the prolonged slowdown is inducing changes in labor market practices. Pressures for change have come from the yen's appreciation in recent years and the stagnant economy that has left many firms with a surplus of labor. Because of Japan's steeply rising wage profiles, population aging has increased the wage bill, adding additional cost pressures to firms. There are plenty of media reports that fundamental labor market change is occurring, but, according to Rebick, the evidence is much less clear.

Rebick examines several institutions that have played major roles in Japanese labor markets since WWII. These include lengthy employment tenure, a focus on acquisition of general job skills rather than specialization, limited mainstream opportunities for women employees, and seniority-based compensation schemes. Using statistical evidence as well as qualitative reports, Rebick explores whether one can find hard evidence of significant change in labor market practices. His results are mixed. In some ways, Japan’s labor markets do appear to be changing. Japanese firms are making somewhat greater use of temporary labor than in the past, and there are reports of increased specialization among workers. The wage profile has flattened overall, and there is also an apparent move toward tying compensation more closely to performance rather than seniority. Wage dispersion has increased for particular age groups.

None of these changes seem likely to sweep away the traditional system of lifetime employment. Rebick calculates that, if anything, Japanese tenure has actually increased in recent years! For prime-age male employees at major firms, it is far from clear whether there have been fundamental changes in the terms of employment or career advancement. Neither is there much evidence of improvement in employment opportunities for females. Women continue to gravitate away from the core job tracks and to have long periods of part-time employment. Rebick argues that these fundamental aspects of the Japanese labor system appear likely to persist for the foreseeable future.

Even the limited changes that are occurring may have important macroeconomic implications. One area is organized labor. With continued flattening of wage profiles and growing emphasis on individual performance, labor unions may hold less appeal for workers. New union memberships have declined markedly in recent years. Another area that we have already touched on is the overall labor market performance, measured by the unemployment rate. Unemployment has risen considerably, but most of the increases have been borne by older men and women of child-bearing years. In Rebick’s view, it is unlikely that unemployment rates will go much higher for core male employees, but it is possible that the more marginal groups will increasingly be used as a safety valve for troubled companies.

4.2. The Regulatory Regime and Industrial Restructuring in Japan

The events of the past decade have forced Japan to steadily adjust its institutions and attitudes. Deregulation has been a particular focus. Thomas Cargill launches the discussion of deregulation in *Chapter 6*, with his analysis of Japan's ongoing financial deregulation and its banking crisis. He shows how the bubble economy and its collapse forced Japan to change both institutions and attitudes underpinning its financial system.

Cargill begins by discussing the type of financial regime that emerged after WW II and analyzes the critical role that it played in Japan's reindustrialization process and emergence as the second largest economy in the world by the 1980s. Elements of this system were already in place before the war. By the first part of the century, Japan's financial sector had developed a distinctive structure that depended heavily on indirect finance. Large banks forged long-term relationships with major non-financial enterprises, often with implicit government approval. The government itself acted as financial intermediary by funneling postal savings deposits to favored projects. The central bank had little autonomy, acting largely as an arm of the Ministry of Finance. In the post-war period, this bank-finance model continued to support Japan's dynamic growth by funneling vast flows of household savings to Japan's dynamic export-oriented firms.

The emergence of new economic, technological, and political forces in the 1970s and 1980s, increasingly rendered the old regime obsolete and in a sense, made the old regime "an accident waiting to happen." As early as the mid-1970s, Japan had become aware of emerging financial difficulties and had begun to undertake modest reforms. The Bank of Japan gained more de facto independence and engineered a successful resolution to the inflationary pressures of the two oil shocks. The Japanese government accomplished limited reform of financial markets, including interest rate deregulation, increases latitude for bank asset diversification, and greater integration with global capital markets. Still, fundamental aspects of Japan's traditional bank-finance model remained.

The asset inflation of the 1980s and the resulting financial distress laid bare the inadequacy of the old system for the new Japanese economy. Cargill shows that the government’s response to the collapse of asset prices and bank balance sheets continued to be rooted in the old regime of mutual support and non-transparency despite market forces rendering this approach counterproductive. Only when a new set of economic and political forces emerged in late 1997 and early 1998, were authorities in Japan finally convinced that a new regime needed to be implemented. Basic components of the new regime included establishment of the Financial Reconstruction Committee in the Prime Minister’s Office to manage the resolution of failed institutions, manage the financial crisis in general, audit and inspect financial institutions, and oversee the operations of the Financial Supervisory Commission. Nationalization of Long Term Credit Bank and Nippon Credit Bank, an injection of public funds into banks meeting stringent qualifying criteria, and the consolidation of several agencies created to deal with the banking crisis indicated a renewed purpose and resolve on the part of the authorities.

Cargill concludes by focusing on the short-term prospects of resolving the financial distress and the need for continued restructuring of financial firms in the private-sector and regulatory institutions. In the short run, he argues that the critical need is for the Bank of Japan to reverse the deflationary process that has characterized Japan throughout the 1990s. Institutional reforms that direct the Bank of Japan to prevent deflation and inflation could help to improve the long-term policy environment. Cargill warns that longer-run problems, such as the potentially large liabilities of the government-run postal savings system, the declining role of banks, and changes in the age distribution of the population must also be addressed if Japan is to develop a more efficient financial infrastructure over the next decade.

In *Chapter 7*, Takatoshi Ito and Michael Melvin examine the Big Bang program of financial deregulation and present econometric analysis of the early impact of the reforms in the foreign exchange market. The term “Big Bang,” borrowed from Great Britain's 1970s program of financial deregulation, is itself a misnomer, as the program is comprised of various reforms in the banking, securities, and insurance sectors, scheduled to be phased in over a four-year period, from 1998 to 2001. The Big Bang began on April 1, 1998 with two measures that effectively "burned the bridges" on implementing future reforms. Controls on foreign exchange transactions were effectively eliminated, and Japanese investors were given the green light to open and maintain accounts with financial institutions in foreign countries. These measures were intended to secure the implementation of the remainder of the Big Bang package, as they effectively open most Japanese financial markets to international competition. If Big Bang reform measures strengthening the competitive position of Japanese businesses are not implemented, then businesses and individuals in Japan could conduct their transactions with more competitive financial firms operating from London, New York, or Singapore.

Major Big Bang reforms include: (1) removing restrictions on banks' marketing of mutual funds to their customers; (2) removing restrictions on financial holding companies, thereby allowing banks, securities firms and insurance companies to be controlled and coordinated within a single company; and (3) ending the segmentation of the insurance industry into three categories—life insurance, non-life insurance, and "other" insurance—and ending many restrictions on the pricing of insurance products.

Ito and Melvin focus their empirical analysis on the effects of the 1 April 1998 deregulation of the foreign exchange market, which ended the monopoly of Japanese banks in foreign exchange trading. This regulatory change should have allowed more Japanese firms and households to diversify their asset portfolios at a lower cost. Since interest rates were lower in Japan than in Europe or the United States, the deregulation could be expected to induce a shift from yen to dollars and a consequent yen depreciation. Movements in the yen-dollar exchange rate are consistent with this hypothesis as the yen depreciated in the period leading up to April 1 and in the week following the deregulation. However, the evidence is far from conclusive, as plenty of bad news on the Japanese economy was revealed during this period, and this news could also have depressed the Yen value.

Ito and Melvin bolster their empirical analysis by conducting econometric analysis of the bid-ask spreads for Japanese and foreign banks in the foreign exchange market. Holding other factors affecting the spread constant, they find that the spreads of Japanese banks, which were higher than the spreads of foreign banks before April 1, converged to the spreads of foreign banks after April 1. Other econometric tests indicate that the deregulation of the foreign exchange market also served to reduce the volatility of exchange rates, holding other factors constant. Their analysis provides important early evidence that the "burning bridges" phase of the Big Bang was completed effectively, increasing the probability that the entire package of financial reforms will ultimately be carried out.

In his essay in Chapter 2, David Weinstein highlighted two contrasting trends in the productivity performances of Japanese businesses. Productivity in Japan’s manufacturing industries had converged with or even exceeded productivity in US manufacturing industries, while productivity in Japan’s highly regulated industries—agriculture, construction, transportation, communication, and energy—had lagged way behind their US counterparts. Weinstein’s findings raise numerous questions concerning the source of these divergent trends. Are they the consequence of continued regulation of service industries in Japan coupled with their deregulation in the United States? Can Japan close the gap by deregulating its service industries along the lines of the US model? Will Japan have the political will to follow through with deregulation if it produces losers as well as winners?

In *Chapter 8*, Edward Wolff begins to examine the divergent trends in productivity between Japan and other OECD countries by investigating whether they are linked to changes in Japan’s industrial structure. He finds that Japan experienced larger changes in its pattern of specialization and industrial composition than two other high-income countries, Germany and the United States. This rapid change in industrial structure raises the important question of whether Japan's newly developed industries may have randomly turned out to be the industries in which productivity growth was relatively low in the late 1980s and 1990s. If this were to be the case, then it would raise new hopes for increased productivity growth over the next decade, as rapid industrial change could leave Japan specialized in new industries with higher productivity growth.

Wolff concludes, however, that Japan's rapid transition to new industries did not retard its economic growth. Using counterfactual methods of analysis, he demonstrates that Japan's productivity growth rates between 1970 and 1995 would not have changed substantially if it had developed the same mix of industries as Germany or the United States. Instead, Japan's slowdown in economic growth was primarily due to declines in the rate of technological progress in almost all industries. In other words, Japan's poor performance stemmed from poor productivity results across its many industries rather than from particularly poor performances in just a few industries. Wolff suggests that this pattern of poor productivity growth is particularly worrisome, as Japan spends a higher percentage of its GDP on research and development activities than the other G-7 countries. How then is Japan to get out of its slump if it is already spending significant resources on improving productivity? While deregulation of industries with low productivity growth may seem a reasonable answer, Wolff rightly cautions that we do not know whether industry regulation is the root cause of the productivity slump in Japan. In fact, economists have generally had a difficult time explaining the reasons underlying long swings in productivity growth, in particular the slowdown in US productivity growth since 1973.

An interesting example of how things are changing at the micro level in today's Japan is the case of the *sogo shosha*, discussed in *Chapter 9* by Örjan Sjöberg and Marie Söderberg. Centrally positioned within Japan's post-war system of trade and manufacturing, these general trading companies have seen their position eroded over the past few decades as the composition of trade and the manner in which it is conducted has changed. In earlier years, the *sogo shosha* were virtually exclusive suppliers of critical trading skills and were much better informed about conditions in foreign markets than most Japanese firms. The long export boom from 1950-89 diffused many of these skills to a vast number of firms involved in international trade, which, as they grew larger, began to have the option of internalizing these operations. As a result, fellow *keiretsu* member companies increasingly made do without the services of 'the master merchants of Asia'.

Sensing that there was no future in their traditional role, the general trading companies opted for a change of direction during the 1990s. They designed strategies that would decisively move the *sogo shosha* away from raw material imports and the exporting of manufactured goods. Instead, foreign direct investment, the provision of infrastructure, and various types of business services other than trade were to be the foci. This change in direction also entailed a more pronounced focus on Asia in general and Southeast Asia in particular as well as increased efforts to forge new alliances with foreign companies. New industries, such as space, media and entertainment, were also mentioned as promising directions for expansion or redirection.

Although these strategies, as formulated by individual *sogo shosha* and their national association alike, have proven less profitable than expected, the shift of emphasis is indicative of the changes underfoot. The Japanese business conglomerate is no longer a world unto itself; increasingly it has had to adapt to the ways of the rest of the world. The cozy relationship between politicians, top civil servants, and business leaders is being broken up, and the information provided by the *soga shosha*, once the eyes and ears of all three groups in foreign countries, has become less valuable to these parties. This change has been accompanied by shrinking price margins on services provided to manufacturing companies within the *keiretsu*, as the services rendered are no longer the exclusive preserve of the *sogo shosha*.

The fact that their attempts during the 1990s to reinvent themselves have had only mixed success — despite efforts to streamline operations, earnings and profits have plummeted — has made further soul searching a favorite activity among the master traders. Trade is becoming less attractive, general trade even less so, and the need to move into an entrepreneurial role is emphasized. According to Sjöberg and Söderberg, this in turn presupposes a restructuring, not only of operations, but also of management. Strategic management and operating functions need to be separated in order to increase flexibility and transparency. Management standards and practices must be realigned to conform to international standards. Speed of decision making and the importance of risk management must be emphasized.

It remains to be seen whether the above measures will prove sufficient to maintain the standing of the trading companies. The s*ogo shosha* have proved resilient in the past and may eventually adapt well to their changed circumstances. Even so, Sjöberg and Söderberg suggest, chances are that Japan's general trading companies will have to contend with a reduced role. If so, it is a sign of the times in an era of increasing liberalization and deregulation throughout Japan.

In *Chapter 10*, Sumner La Croix and James Mak survey the course of regulation and deregulation in four major industries—airlines, electricity, telecommunications, and retailing—and analyze the economic, political, and social factors that paved the way for the continuing regulatory reforms of the 1980s and 1990s. They argue that the origins of industry regulation can be found in the control economy of World War II. The American occupying authorities used the command-and-control apparatus of the Ministry of Finance and the newly created Ministry of International Trade and Industry to implement their economic directives, particularly those associated with the Dodge Line. With the restoration of Japanese sovereignty in April 1952, the regulatory system quickly came to be supported by a nexus of interest groups and supporting ideologies. Administered by a corps of elite bureaucrats, Japan’s regulatory measures have often been far broader and more detailed than those called for by the enabling statutes, typically taking the form of administrative guidance (*gyosei shido*). Regulation alleviated business and government concerns about "excessive competition" by carefully limiting (or prohibiting) entry into the regulated industry and restricting price competition. In many industries e.g., rail, telephone, and airlines, industry regulation was coupled with extensive public ownership of major firms.

The post-WWII regulatory system was able to achieve its initial objectives of fostering rapid economic growth without major tears in the social fabric. In agriculture and retailing, small firms were protected against competition from large firms. By providing a measure of "ex post equity" to the losers from economic development, most industry regulation acted to temper the process of creative destruction and slow economic growth in particular industries. The effect on overall growth was, however, surely more ambiguous. By reducing the social conflicts arising from rapid growth, protective industry regulations may have helped to maintain the stability of the overall economic system during a period of rapid transition from labor-intensive to capital-intensive industries.

In their case studies of four industries, La Croix and Mak find that there has been ongoing privatization and deregulation in each industry since the early 1980s, with the pace quickening significantly in the 1990s in response to the post-bubble Japanese slump. Despite recent deregulation measures, Japan’s transportation, public utility, and communication industries are still moderately to highly regulated. Most regulation continues to be informal, administered by national government ministries. Entry and price regulations have been somewhat relaxed in most industries, but are still binding constraints. In Japan “liberalized entry” typically means more competitors, not free entry. Licenses to enter are still granted on an “as needed” basis. Simple oligopoly models predict that additional competitors will reduce industry prices somewhat, but perhaps not as low as in other countries with a similar number of firms, because of the higher barriers to entry. These barriers reduce competitive pressure normally provided by potential entrants. In sum, regulatory reform has increased competition in Japan, but the basic parameters of regulation have not changed in most industries, with the exception of retailing and finance.

La Croix and Mak argue that deregulation in Japan in the 1980s and 1990s was primarily driven by competitive pressures stemming from increased globalization, and that this channel will continue to be the primary source of deregulation in Japan after 2000. Ideological suspicion of the adverse distributional effects of the free market, close ties between government ministries and regulated firms, and administrative reluctance to shed regulatory powers slowed the pace of regulatory reform over the last two decades. In the absence of more fundamental political reforms, La Croix and Mak expect that this slower pace of reform—more European than American in style—will likely continue.

4.3. Foreign Direct Investment and Regional Integration

This part of the book covers the rapidly changing international aspects of the Japanese economy. *Chapter 11*, by Magnus Blomström, Denise Konan and Robert Lipsey, examines how inward and outward foreign direct investment (FDI) have influenced the restructuring of the Japanese economy and can be expected to continue to do so in the future. Outward investment is a way of maximizing the rents on the accumulated knowledge and skill of a country´s firms, or preserving them as long as possible when the country itself has lost its comparative advantage in their industries, and the industries, or parts of them, must relocate. Inward investment may bring new firm-specific skills and new industries to countries that lack them, or preserve the rents on workers´ skills in sectors where domestic firms have lost their firm-specific advantages.

Blomström, Konan, and Lipsey find that outward investment has helped Japanese firms to sustain foreign market shares and contributed to the restructuring of the Japanese economy away from older industries. By shifting from exporting to affiliate production, there has been a geographical reallocation of the activities of Japanese firms, particularly those of multinational manufacturing firms. They find, however, that Japanese outward FDI is still not very large relative to the Japanese economy, despite the rapid growth since the mid-1980s, and that there is still scope for significant increase when compared with the levels of most other OECD countries. The outsourcing and relocation of production are particularly expected to affect labor intensive manufacturing operations, not least because of demographic factors. On the domestic scene, this will facilitate the necessary restructuring of the Japanese economy towards more advanced activities with higher value added.

Inward FDI will presumably have an even stronger impact on the restructuring of the Japanese economy, according to Blomström, Konan, and Lipsey. Although the stock of inward foreign direct investment is still very small, there are important changes under way. Deregulation has opened up much of the industrial and service sectors to foreign multinationals. In combination with the economic crisis, this has begun to weaken the cross-shareholding relationships within the *keiretsu* groups, and has facilitated mergers and acquisitions between Japanese and foreign firms. The consequences of increasing foreign participation in the Japanese economy are likely to be highly beneficial. The level of competition and the inflow of foreign technology will increase, with higher productivity growth as a major result.

In *Chapter 12*, Steven Globerman and Ari Kokko discuss some future developments in the economic relationship between North America and Japan, and try to assess the implications of these developments for the Japanese economy and Japan´s economic policies. Their exercise is based on an overview of recent trade and investment flows between the two regions, as well as a brief assessment of how these linkages are likely to change over the next 10-20 years.

Regarding trade relations between the two regions, Globerman and Kokko argue that the US is likely to remain Japan's preeminent trading partner and a major contributor to Japan's trade surplus for the foreseeable future. However, Japan is becoming a relatively less important trade partner for the US, and this trend is also likely to continue. At the same time, they project that Japan is likely to become an absolutely and relatively more important destination for US FDI, and that this increase in FDI has the potential to transform US-Japanese economic relations in more substantial ways than bilateral trade negotiations have done in the past. The sectors that have particularly great potential in this context include financial services, health care, tourism, and consulting. Domestic demand for the outputs of these sectors will grow in Japan, partly for demographic reasons and partly because of the relatively high income elasticities characterizing those outputs. US companies also enjoy well-recognized firm-level advantages in a number of these sectors. Indirect economic integration between Japan and the US might also proceed through technical cooperation in areas such as defense, health and environmental protection, where companies and non-profit institutions in both countries are carrying out research and development activities.

Although future developments in these areas offer potential economic gains, they also contain seeds of conflict. It seems likely that relations with North America will influence the direction of Japanese economic policy primarily through US threats to the bilateral trade relationship rather than through perceived gains to closer economic integration. In the trade area, Globerman and Kokko foresee continued US pressure on

Japan to reduce various non-tariff barriers to trade and to continue to reform competition policy. This type of pressure is not new to Japan, but US threats of retaliation may become more credible as Japan's relative importance as a trading partner for the US diminishes. Slow progress in resolving outstanding trade disputes may provoke the United States to focus its policy attention elsewhere, including a renewed commitment to implementing a Free Trade Area of the Americas Agreement, deeper economic integration with the EU, and perhaps also closer economic relations with China. The consequences for Japan might be an increasingly isolated position among the developed countries in formulating trade and investment policies, as well as heightened risks of serious disruptions of its trade flows with North America.

One consequence of the tougher American negotiation stand is a potential for much higher economic costs to Japan associated with its maintaining formal and informal barriers to protect domestic producers. At the same time, the continued severe recession in Japan and the boom in the US are promoting increased US FDI in Japan. Increased FDI flows offer the potential for mutual economic gains. It would not only contribute to making the Japanese economy more dynamic, but it could also diffuse frictions that characterize trade relations between the United States and Japan. However, in most industries, foreign investors have been kept out by the same barriers that impede the entry of new domestic firms. What is needed to facilitate FDI in these sectors is not only more active investment and competition policy, to keep markets contestable, but also changes in some of the structural characteristics of Japanese industry, such as cross-shareholding, discriminatory treatment of minority shareholders, rigid labor markets, and so forth.

Increased technological cooperation between the United States and Japan offers the prospect of mutual gains in the form of increased innovation in "public goods" activities, such as defense and environmental protection. It might also diffuse US-Japanese tensions surrounding US policy concerns that it has undertaken a disproportionately large share of basic R&D carried out by developed countries, while Japan has disproportionately exploited the technological spillovers of US- funded basic research for commercial purposes. Bilateral cooperation might involve the Japanese government assuming a heavier funding responsibility for basic research having "public goods" qualities, possibly in collaboration with US academic and government research organizations.

In summary, the paper by Globerman and Kokko points to a number of areas where the bilateral relationship between Japan and North America is likely to result in pressure for reform of the Japanese economy. In some cases, this pressure will likely succeed in bringing about significant changes in the Japanese economy. In particular, US calls for an opening up of the Japanese service sector to increased foreign ownership will coincide with increases in Japanese domestic demand for many services, as a result of demographic and economic factors. It is also possible that a substantially increased presence of US-owned companies in Japan will contribute to further Japanese trade and investment liberalization, as well as to further domestic deregulation, as the perception spreads among Japanese interest groups that the rents generated by domestic protection are increasingly being shared by foreign producers.

A couple of decades ago, Ezra Vogel's book *Japan as Number One* illustrated the common view that the US and Japan were the main players in the race for the top position in the world economy. Recently, however, international statistics on trade and market size have established a ranking with *Japan as Number Three*. The emergence of the European Single Market in the early 1990s has made the European Union (EU) the world's largest exporter, the second largest importer, and the world's second largest market. The establishment of the European Monetary Union (EMU) in 1999 and the introduction of the European common currency, the euro, have strengthened the Single Market and have also led to increased coordination of national economic policies within the EU. This development has been somewhat of a surprise for both Japan and the EU—in many respects, the relations between Japan and Europe form the weak link in the Japan-US-Europe triad. The central question in *Chapter13,* written by Ari Kokko, Bruce Henry Lambert and Fredrik Sjöholm, is whether European integration will motivate a change in Japanese behavior towards Europe.

Kokko, Lambert and Sjöholm discuss how European integration has influenced and will continue to influence relations between Japan and Europe. The first part of the chapter describes Japanese past trade and foreign direct investment relations with Europe. The second part discusses how the Single Market Program, the EMU, and the plans for an eastern enlargement of the EU may affect Japanese trade and foreign direct investment.

At the macro level, it is clear that the establishment of the Single Market and the EMU have made Europe more similar to the US as a potential destination for Japanese exports and as a location for Japanese FDI. This implies significant increases in the trade and investment contacts between Japan and Europe. Comparing Europe with the US, Kokko, Lambert and Sjöholm suggest that the largest potential for increased Japanese exports and direct investments should be found in the automobile and electronics industries: in both these industries, Japanese firms hold significantly smaller market shares in Europe than in the US.

However, developments at the micro level are likely to temper these conclusions. Various kinds of trade and investment barriers have restricted Japanese sales and investments in some European markets in recent years, and are likely to limit the Japanese responses to European integration in the future as well. Moreover, the industrial policies of various EU governments, e.g. in the form of investment subsidies to foreign as well as domestic investors, may affect the location as well as the volume of inward investment. It is also difficult to predict how the closer contacts between Japan and the EU in political issues, economic policy, and other areas of common interest will affect the extent of trade and investment contacts. Yet, in the longer run, it is very likely that Europe will receive more attention from Japan. How much depends on how European integration progresses. In particular, it will be important to follow the development of the EMU, as well as the plans for the Eastern enlargement of the Union.

In the final chapter (*Chapter 14*), Shigeyuki Abe and Chung Lee discuss the implications for Japan of continued rapid economic development in China. They assume that China will continue with its market-oriented reforms and, thus, maintain high rates of economic growth, albeit lower than the roughly 10 per cent growth rates of the 1980s and 1990s. Abe and Lee then argue that the economic relationship between China and Japan has closely replicated the historical relationship that Japan had with the West while it was catching up, as well as a similar relationship between Japan and other newly industrializing economies in Asia. This "flying geese" pattern of development portrays the development of a technologically lagging country as a progression through successive stages of increasing technological sophistication. Thus, a developing country first imports simple labor-intensive products, next undertakes their domestic production, and then finally exports them to the economies lagging even further behind in technology. Its repeats this process as it moves up the product ladder to more sophisticated, capital-intensive products until it finally catches up with the industrially advanced countries of the world. Abe and Lee caution that China's process of catch-up may be slower than Japan's due to the millions of unskilled, uneducated agricultural workers still to be absorbed by the labor-intensive manufacturing sector.

How will China's expanding economy affect Japan? First, it may help to revitalize the Japanese economy by expanding the market for Japan's sophisticated capital equipment and technologies. Second, the growing technological capability of China and its abundant supply of cheap labor will make China an attractive host country for Japanese overseas direct investment. Third, as Japan's net private savings rate declines, a by-product of its rapidly aging population, and China's net private savings rate increases, China may begin to supply Japan with capital.

More importantly, the Japan-led flying-geese pattern of development of the second half of the 20th century may be replaced by a new multi-polar East Asia, with Japan and China as its major players. Many politicians and academics in Japan are, however, wary of China's rise and now view China as being overbearing toward the region and, worse, as having hegemonic ambitions. Whether or not the large potential gains from trade, investment, and technology exchange between the two countries are realized will depend very much on how the region's two major powers relate to each other politically. Lee and Abe argue that development in China will induce structural change in Japan and that close coordination of the two countries' economic policies will be needed to ensure a harmonious relationship. At the same time, the two countries must learn to coexist as great powers in the Asian region, an arrangement that is without precedent. The challenge is to see whether both objectives can be achieved simultaneously.

5. Conclusion

Change is a tradition in Japan. More than once in the 20th century, Japan has been forced to restructure its economy and institutions to meet new challenges. Today, that process of restructuring is underway again, but not always in ways that are transparent. Creeping, incremental change in many areas leaves the danger that Japanese and foreign observers will not recognize Japan's new economy until long after it is up and running. This volume strives to identify key developments that over the next decade may have a decisive impact on Japan's economy. The historical record cautions us from engaging in simple projections of growth or decline within today's public and private institutions. Rather, the contributors have tried to pin down ongoing or potential institutional, demographic, and structural forces that will drive change in coming years.

While any such list is speculative, it is instructive to note the wide compass of changes that are already afoot in Japan. Some of these are widely acknowledged, both in Japan and abroad; others may have a stealth-like quality to them, their true import hidden from view to all but the most savvy of futurologists. The overall message, however, is that it would be a mistake to take Japan's present predicament, bad as it is, for a good guide to the future. A Japan increasingly geared to the requirements and pressures of globalization is waiting in the wings.

While it is not particularly realistic to expect a return to the rates of growth and speed of structural change experienced during the golden years of post-war ascendancy, Japan still has the capacity to excel in many areas. It may not be the undeniable leader in many industrial fields, and the 1990s has served to widen rather than narrow the per capita income gap (computed with purchasing power parities) with the United States. But this does not imply that Japan has fallen behind once and for all. Just as in the past the overall economy has proven surprisingly resilient in face of devastating shocks, Japanese industry has shown a remarkable ability to reinvent itself. And there is little to suggest that this particular talent has been lost. As a business climate is slowly created allowing entrepreneurial energies to be released, it does not take a great leap of faith to see in Japan an economy that possesses a good platform for future growth and renewed competitiveness.

To be sure, one also sees a Japan with its fair share of problems, ranging from still-stifling rigidities in labor and retail markets to mounting demographic pressures in the form of rapidly increasing dependency ratios. And while issues of institutional adjustment are being addressed—sometimes reluctantly, sometimes less so—the question remains whether the pace of institutional change can keep up with Japan's rapidly changing economic environment. Even here, it is worth noting how economic changes, such as the ongoing demographic shifts, are refocusing public debate and prompting changes in private and public policies. A case in point is the keen interest shown in the experiences with social security and pension reform undertaken in the other industrialized economies. Another is the equally intense focus on the pros and cons of the educational system, itself under intense pressure to adapt to changing circumstances and expectations.

What will the new Japanese economy look like? It will be founded on the new demands of a much older population that will want new products and services from the private and public sectors. It will be a more balanced economy, less dependent on traditional export industries for growth. It will be a less regulated economy in many spheres, if not the wide open marketplace that the West might favor. And government will continue to play a visible (but not always transparent) role in promoting egalitarian as well as competitive aims.

Whatever the face of Japan's new economy, the outside world neglects new Japanese products, industries, and institutional innovations at its own peril. To other industrial economies, Japan remains a formidable competitor and a source of ceaseless product and process developments. It should also be seen as a source of new policy experiments that may help others in similar straits find workable solutions. Just as Japan's development juggernaut became an important object of study in the post-war period, Japan's new economy deserves serious attention at the dawn of the new millennium.

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